

Transition Issue 1: Criteria for Reduced or Streamlined Regulation of Price Cap LECs

Transition Issue 1a: What is the current state of competition for local exchange and interstate access?

Transition Issue 1b: What criteria if any should be used for determining when reduced or streamlined regulation for price cap LECs should take effect? For example, in determining whether a service is subject to sufficient competition to be moved from price cap regulation to reduced or more streamlined regulation, should the Commission take into consideration (1) the nature and extent of any barriers to market entry and exit (e.g., regulatory, economic, or technological obstacles), (2) the existence of potential and actual competitors and, if so, what role should the existence of potential and actual competition play in determining whether to reduce or streamline LEC price cap regulation, (3) the extent to which those competitors have the facilities to serve LEC customers, (4) the willingness of customers to use competitors' services and, if so, how should this criterion be measured, (5) the competitors' market share and, if so, how should the term "market" be defined, (6) pricing trends, (7) the effect of expanded interconnection, (8) differences in competition in different geographic locations or regions, and differences in demographic characteristics, such as whether services are available to all groups within a broad community or area, or (9) other factors.

Transition Issue 1c: In what circumstances will a LEC no longer control essential "bottleneck" facilities for some or all of its services? How will the Commission be able to identify these circumstances in practice?

Transition Issue 1d: What ability do CAPs and others have to compete with the LECs? What data indicate the level of actual and potential competition from CAPs and other providers? For example, such data may include the CAPs' profit levels, stock price trends, revenues, or other measures which reflect the CAPs' ability to compete.

Transition Issue 1e: What impact should price cap LEC entry into related industries (e.g., cable TV) and BOC entry into inter-LATA marketplaces have on the LEC price cap plan?

The monopoly on local exchange and interstate access held by the RHBCs remains intact: The perception that competition is rampant is simply wrong.

There is a perception that local competition has arrived due to recent developments in the industry, such as expansion of alternative access provider services, FCC-mandated interconnection and co-location requirements, the growing use of wireless services, even multibillion dollar alliances between traditional telecommunications carriers and potential future alternative local service providers. These developments certainly increased prospects for competition but their actual economic impact on the traditional local exchange monopolies is, at the present time, minimal. Moreover, barriers such as the enormous capital requirements necessary to build alternative local networks across the country, the time it will take to develop a customer base and the power of the incumbent local exchange carriers to frustrate competitive entry assure that effective competition will not occur any time soon.

Alternative access providers have only captured an extremely small portion of the market and are much smaller than their LEC competitors in a number of important factors. (See Figures 6 and 7 below.)¹⁵⁹ Aggregate revenues, which are paid by long distance carriers and end users, for access services of all Competitive Access Providers (CAPS) combined are *less than one percent* of total monopoly local exchange carrier access revenues. As William Baxter stated “[t]he local telephone network monopoly is the tollgate through which 99% of America’s long distance traffic still must pass. It’s true that new technology exists today that allows big business customers to bypass the local network, but that 1% of the total market doesn’t add up to competition.”¹⁶⁰

Many have speculated that wireless service providers as well as cable TV companies are some of the most serious competitors to the LECs. It is important to note however, that wireless services are not substitutes for local service today. The costs, capacity constraints, quality and reliability of wireless services relative to basic local service preclude direct substitution today. In addition, “[m]ore than 95% of wireless calls are dependent on at least one local network, either at the calling or the receiving end. There are no cost or technology changes on the horizon that promise to alter these basic relationships of dependence and monopoly.”¹⁶¹ Further, no cable system offers local telephone service today. In view of the vast investments that are required it may be some time before the majority of consumers would have a competitive alternative available.

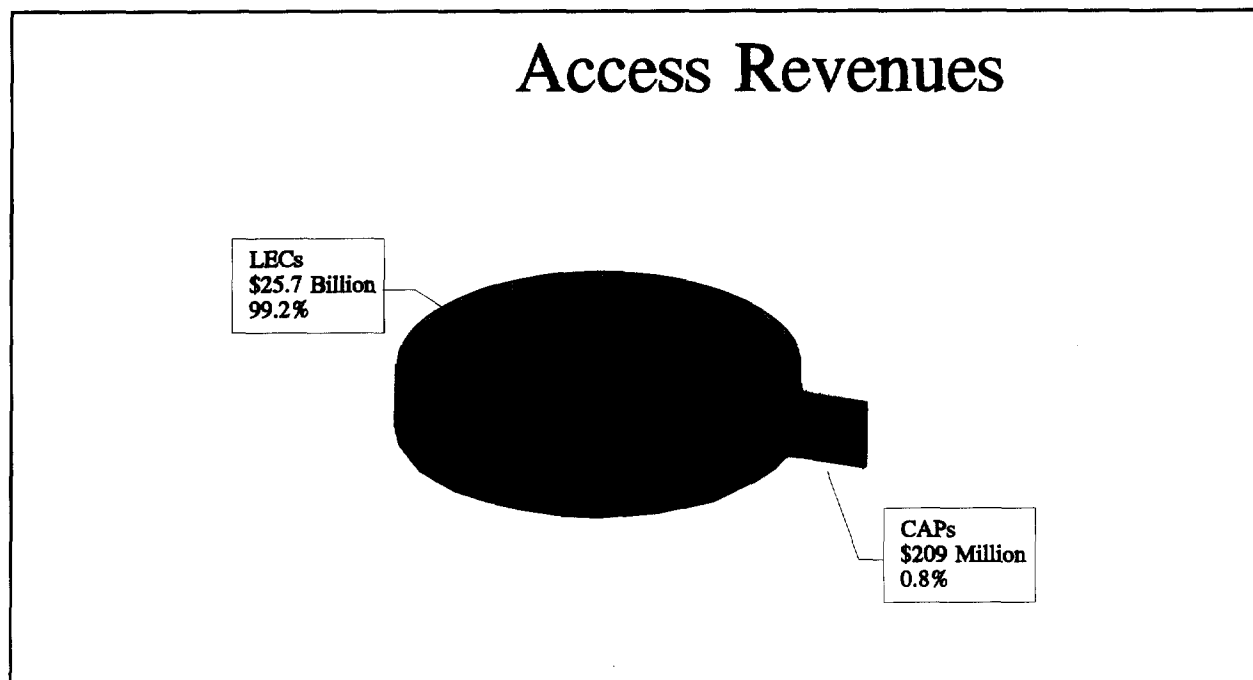
Between now and the year 2000 the seven RBHCs will generate approximately \$100-billion in recurring depreciation charges, creating cash flow for reinvestment at a level that

159. Source of data for Figures 6 and 7 is found footnote 146 *supra*.

160. Statement of William F. Baxter in “Toward a Free Market in Telecommunications,” *The Wall Street Journal*, April 19, 1994. For further discussion see, “The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers,” Economics and Technology, Inc. and Hatfield Associates, Inc., February 1994.

161. *Id.*

Figure 6. Alternative access providers have captured a very small portion of the market



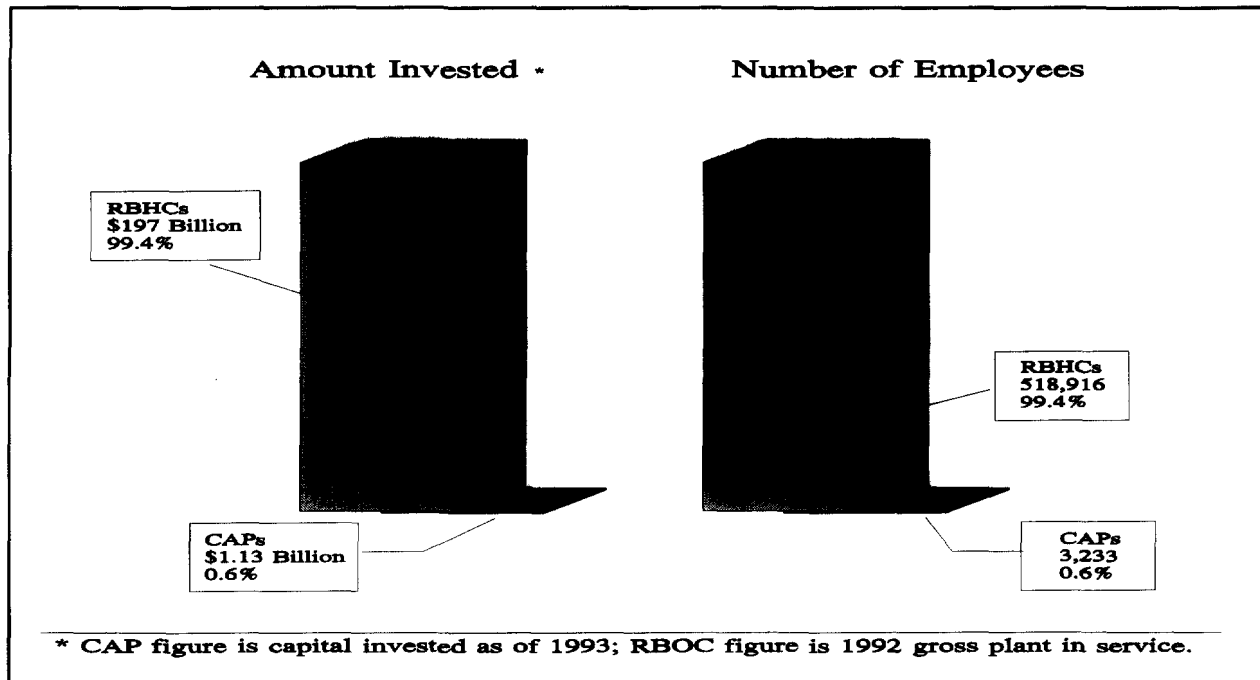
dwarfs all of the potential competitors combined, and all without risk to RBHC shareholders. Although major segments of the local telecommunications marketplace may become competitive in the future, the RBHCs, by virtue of their extensive and ubiquitous local networks, will maintain "bottleneck" control of essential interconnection functions for a significant period of time.

The public debate over the course of U.S. telecommunications policy has been heavily influenced by visions of "information superhighways" whose ultimate development demands BOC involvement in all industry segments, including those "lines of business" from which the BOCs are barred under the terms of the *Modification of Final Judgment (MFJ)*.¹⁶² Incredibly, any such "essential" role for the BOCs serves to underscore their fundamental bottleneck position and belies their claims of effective and pervasive competition: *Clearly, if competition were as extensive and formidable as the BOCs would suggest, then any number of alternative entities would be capable of meeting these demands, were BOC participation not permitted.*

Competition is likely to increase for some *components* of local telecommunications service over the next five to ten years. However, the level and scope of competitive entry is unlikely

162. *United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131, 226,227 (D.D.C 1982) ("*Modification of Final Judgement*" or "*MFJ*"), *aff'd sub nom.* *Maryland v. United States*, 460 U.S. 1001 (1983).

Figure 7. Alternative access providers are but a shadow of their LEC competitors in a number of important respects



to be sufficient to eliminate or even significantly reduce the control of essential facilities by the BOCs. Additional time is required for these markets to mature and for effective and *sustainable* competition to emerge.

Transition Issue 2: Transition Stages

Transition Issue 2: What regulatory methods for reducing price cap regulation or streamlined regulation should be adopted for LEC services as those services become subject to greater competition?

The price cap plan as structured, with the basket modifications discussed in Transitional Issue 3, will allow the regulation of LEC services to adjust automatically as (if) those services become subject to greater competition.

Revision of the existing price cap baskets to a structure that reflects various levels of competition for services (and with correspondingly different regulatory requirements for each of the baskets) will make it unnecessary for the Commission to plan additional steps for "reducing" or "streamlining" regulation of LECs. That "reduction" or "streamlining" will become an integral part of the overall price cap process. Such a system will grant additional pricing flexibility to the LECs only at such time as market conditions warrant for *individual services*, and it will do so without requiring this Commission to make a determination as to the overall status of competition for LEC services, and without requiring a major overhaul of the existing price cap mechanism.

Transition Issue 3: Revisions to Baskets

Transition Issue 3: Whether and how the Commission should schedule revisions in the composition of price cap baskets as local exchange access competition develops. Should the Commission adopt a set of procedures that would rebalance baskets in response to specified changes in market conditions?

The Commission should revise the overall basket structure in a manner that will accommodate the transition toward competition.

The Commission should not specifically “schedule” any revisions to the price cap baskets “as local exchange access competition develops.” Rather, the Commission should revise the overall basket structure in a manner that will accommodate the transition toward competition. As discussed in response to Baseline Issue 2, an improved system for LEC access services would be to affirmatively design baskets with specific “competitive status” in mind, and assign services to those baskets (and move services between baskets) as conditions warrant. A basket system that classifies services based upon the level of competition for an individual service, rather than into broad categories such as switching and transport would facilitate the development of different levels of pricing flexibility for different services in the future. Such a revised basket structure could also retain a modified version of the “service band” concept found in the existing basket structure to limit the level of pricing flexibility within those baskets with services that are not subject to the discipline of competitive market conditions.

With baskets based upon competitive classifications appropriate levels of streamlining and flexibility could be granted to each basket as warranted and services could be moved between and among the baskets. LECs would, of course, be required to file data with the Commission demonstrating the appropriateness of moving a service out of one basket and into the next, and interested parties should be able to comment upon the evidence provided. As discussed in response to Transitional Issue 2, movement to a basket structure of this type will allow for the Price Cap plan to transition to an environment in which individual LEC services are subject to increasing degrees of competition without requiring a major overhaul of the plan to accommodate that competition.

Transition Issue 4: Service Quality, Network Reliability, and Infrastructure

Transition Issue 4: Whether and how the Commission should revise its monitoring or LEC service quality, network reliability, and infrastructure as part of any transition plan.

The Commission must monitor LEC service quality, network reliability and infrastructure not only to ensure that adequate service quality is maintained, but also to ensure that service quality is not used as justification for unrelated infrastructure enhancements.

As we discussed in response to Baseline Issue 7, it remains important for the Commission to monitor and be concerned with ensuring the maintenance of adequate and reliable service for all customers. However, in addition to monitoring LEC behavior to ensure that adequate service quality for "plain old telephone" service is maintained, the Commission must also carefully monitor LEC behavior to ensure that the LECs do not use the Commission's quality of service concerns as an excuse to implement infrastructure enhancements, network upgrades, and/or technological advancements that are actually intended for some other purpose. Technology deployment decisions are *not likely* related to providing *high quality* existing services (i.e., basic universal service as it is defined today). The deployment of the new technology is more likely related to plans provide new, competitive services. The Commission must hold the LECs to strict quality of service standards but also ensure that technology deployment decisions related to infrastructure enhancements and upgrades are not justified as service quality investments.

Transition Issue 5: Frequency of Revision Under Price Cap Regulation

Transition Issue 5: When should the Commission next review the price cap LECs' performance? How frequently should the Commission conduct subsequent reviews?

A three-year review cycle with a comprehensive scope should be maintained so as to permit all influencing factors to be addressed and, where necessary, adjustments to be made.

The frequency and character of reviews of price cap plans has been a matter of considerable controversy at both the state and federal levels even before these plans were adopted and placed into effect. LECs have argued that review proceedings that are unduly frequent and that may involve modifications to an existing mechanism amount to the same thing as rate of return regulation, which price cap regulation was supposed to avoid. Others have argued that the various uncertainties and inexperience with this new form of regulation, particularly in its formative period, demand frequent and comprehensive reviews with adjustments and "mid-course corrections" as needed to achieve the established regulatory goals.

If it were up to LECs, there would be no review of price cap regulation systems, and if such reviews were conducted there would be a formidable bias against modification of the plan once established. Certainly that has been the argument of the LECs in California with respect to the CPUC's current review proceeding. There, the LECs claim that any "tinkering" with the original price cap formula and associated parameters would be tantamount to an outright reversion to RORR. In Massachusetts, NYNEX has just proposed an alternative regulation plan that would last for ten years without review or modification by the regulatory agency. The LEC philosophy seems to be "wind us up and let us go," a sort of "damn the torpedoes, full speed ahead" approach.

In the instant situation, the Commission recognized at the outset that a review of its LEC price cap system after three years of operation was required in order to assure that the goals of the plan were being satisfied and to make adjustments where necessary and reasonable. Specifically, the Commission stated that the purpose of the review was to "ensure that the incentives created in the plan operate in the public interest" and to "measure the success of our regulatory program and ensure continued high quality service to ratepayers."¹⁶³ The present review is readily justified on that basis, even if such reviews are not required as frequently in the future.

163. *LEC Price Cap Order* 5 FCC Rcd 6786 (1990) at para. 20.

LEC Price Caps: Fixing the Problems and Fulfilling the Promise

As we noted in our discussion of General Issue 1, however, the premise of the LECs' opposition to frequent reviews and potential regulatory adjustments is fundamentally flawed and is certainly not consistent with the "competitive result" goal of economic regulation. In a competitive market, a "review" of each firm's performance occurs continuously through the discipline of the marketplace itself. If one firm in a competitive industry fails to maintain adequate product or service quality, or raises prices above competitive levels, or fails to achieve normal productivity growth levels for the industry, then others will come along to capture some or all of its business. Regulation is intended to replace the forces of competition where they are not able to exist, and the adoption of price cap regulation does not diminish or alter that requirement. It makes no more sense for a telecommunications utility operating under noncompetitive market conditions to be relieved of periodic regulatory reviews under price cap regulation than it would under traditional RORR; all that should change is the character, and perhaps the frequency, of such reviews.

In a competitive market, firms cannot retain the gains from improvements in operating efficiency or adoption of new technology on an indefinite basis. Over time, these gains are captured by the overall marketplace, and individual firms are forced to pursue still more efficiency and technology opportunities in order to "stay ahead" of the larger market. It is essential that under price cap regulation the Commission provide the same kind of discipline as one would expect in a competitive market. This can be accomplished through a triennial review in which all elements of the price cap system are subject to examination and modification. A price cap LEC does not lose its incentive to innovate, to improve efficiency, or to develop new markets for its services merely because, at the end of a three-year period, it may be required *in the future* to "give up" certain of these gains through, for example, an upward adjustment in its X factor. That the potential gains from such initiatives are not as great under period reviews than under a "let 'em loose" philosophy is not disputed, but in a competitive market the latter scenario, in which benefits are retained in perpetuity, is simply not a realistic competitive outcome.

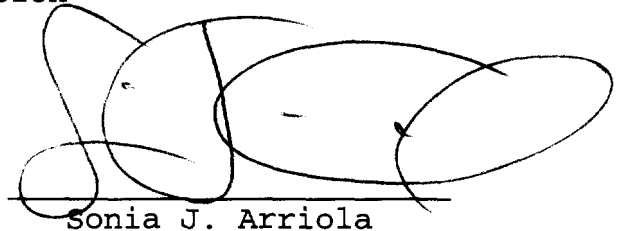
In addition to maintaining a three-year review cycle, it is equally important that the scope of the review be maintained at a comprehensive level so as to permit all influencing factors to be addressed and, where necessary, adjustments to be made. LECs should be on notice that the parameters of their price cap formulas are subject to reexamination and revision in the context of maintaining consistency with a competitive result. That is not to say or to suggest that refinements need be particularly granular or that each such review would require affirmative decisions on relevant price cap parameters. Indeed, even the scope and character of subsequent reviews could well continue to be an issue in each review proceeding. What is important is that the Commission be open to make the adjustments necessary to capture changes in the competitive, technological and business environment that may arise from review to review, and that it continue to impose the discipline of regulation until and unless that discipline can be adequately replaced by marketplace forces.



CERTIFICATE OF SERVICE

I, Sonia J. Arriola, a secretary in the law firm of Gardner, Carton & Douglas, certify that I have this 9th day of May, 1994, mailed, via first-class mail, postage prepaid, a copy of the foregoing **COMMENTS OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE** to the following:

- * Mr. William A. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554
- * ITS
1919 M Street, N.W., Suite 246
Washington, D.C. 20554
- * Mr. A. Richard Metzger, Jr., Acting Chief
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 500
Washington, D.C. 20554
- * Tariff Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 518
Washington, D.C. 20554



Sonia J. Arriola

- * By Hand Delivery